STATEMENT OF REP. JOHN J. LaFALCE, RANKING MEMBER
COMMITTEE ON FINANCIAL SERVICES
HEARING ON ANALYST INDEPENDENCE

July 31, 2001

Mr. Chairman and Mr. Kanjorski, I want to thank you for holding this second set of hearings on the important issue of analyst independence. I look forward to hearing the perspectives of the SEC and representatives of the media on this issue.

Your hearings, Mr. Chairman, and my many meetings with market participants, regulators, academics and constituents, have increasingly convinced me that analysts conflicts have seriously eroded confidence, not only in the capital formation process, but in the way stocks are evaluated by investors who seek objective advice in a highly complex marketplace.

It has also become clear to me that the analysts and their role in boosting and supporting the stock price of certain companies is but one piece in a series of activities that contributed to the market exuberance of the late 1990s and the early months of this century. We must redress these practices.

The centrality of the market as both the measure of a company=s success and a fundamental source of wealth creation for insiders has tilted companies= attention toward their stock price and away from the fundamentals of their business. Executive compensation is now deeply intertwined with the performance of a company=s stock. The stock price, in turn, is very much affected by the expectations of the securities analyst and the investor community. Companies live and die by meeting analysts= predictions each quarter. Missing the estimates by as little as a penny can send a company=s stock price plummeting, even when there has been no substantive change in the firm=s condition or prospects.

Since your last set of hearings, Mr. Chairman, the SIA, in an effort to stem the public and vocal tide of criticism, released its voluntary guidelines on the conduct of securities analysts. Shortly after its release much of the industry claimed they were already following these guidelines. In response, Ms. Unger was quoted in the press as saying, that this would "suggest that perhaps the [guidelines] need to be enforced more stringently." Perhaps so. Shortly following those remarks, in a very positive, but telling step, Merrill Lynch and Credit Suisse First Boston, amongst others, barred their analysts from owning the stocks that they cover. In my view this move was a clear indication by the industry that something is very wrong. It is also an indication that the wrong can be righted.

As result, I have written to Ms. Unger and the NASD on two occasions to call for rulemaking beyond the enhanced disclosure recently proposed by the NASD to amend Rule 2210. We know that the role of the analyst is both a mechanism to win business and a voice to speak objectively about the business fundamentals of the companies they cover. This advice is relied upon by large and small investors alike. What is at risk is a person's retirement, and therefore a person's financial security and fortune. **Conflicts are not simply facts to be disclosed.** Conflicts of interest undermine the objectivity of the analyst and the efficacy of the work that they do. Like any profession that requires trust by the public, conflicts need to be minimized or eliminated, **not simply disclosed.** Lawyers, when they appear to serve two clients with opposing interests, must necessarily withdraw, or otherwise eliminate the conflict or seek a waiver by both clients. Is this any different? Aren't investors every bit the client that the issuer is? Therefore, I have suggested to Ms. Unger, and I invite her to respond today, to the following recommendations:

1. To affirm, through regulation, the actions of Merrill Lynch and CSFB, by banning securities analysts from owning or having an interest in the stocks that they cover.

2. Engage the academic community, the NASD and market participants to arrive at a workable construct that will alter the present compensation structure of analysts to separate analyst compensation from their investment banking function and reward them based on the quality of their research.

3. Consider requiring securities firms to disclose on each research report or recommendation, how many issuers they cover and an aggregate breakdown by category, of the ratings assigned to these issuers. For example, XYZ investment covers 200 public companies, of these companies, 50 are "strong buys," 100 are " buys," 49 are "holds," and 1 is a "sell."

I made additional suggestions to the Commission in late June following your first hearing, Mr. Chairman. Without objection, I would ask that it be made part of the record. I also support many of the modest changes suggested by the NASD in its proposed rulemaking.

Mr. Chairman, I am increasingly concerned that industry self regulation may not be sufficient to guard against the problems and abuses we are seeing, and that more disclosure of these conflicts, in itself will not suffice to protect the individual investor. I urge the regulators to act quickly to eliminate these conflicts to restore the confidence that some have squandered. **If the regulators do not, Congress must**.